

# Roth 401(k) and Roth 403(b)

## *Qualified Roth Contribution Program*

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) contained a new code section, IRC Sec. 402A, effective January 1, 2006, which allows an employer to add a “qualified Roth contribution program” to a regular 401(k) or 403(b) qualified retirement plan.<sup>1</sup> These plans are popularly known as a “Roth 401(k)” plans.

### Qualified Roth Contribution Program

Under a regular 401(k) or 403(b) plan, a participant chooses to defer a portion of his or her compensation into the retirement plan. Such “elective deferrals” are made on a **pre-tax** basis, any account growth is tax-deferred, and withdrawals are taxed as ordinary income.

In a qualified Roth contribution program, a participant can choose to have all or part of his elective deferrals made to a separate, designated Roth account. Such “designated Roth contributions” are made on an **after-tax** basis. Growth in the designated Roth account is tax-deferred and qualified distributions are excluded from gross income. Other points:

- Separate accounting and recordkeeping are required for the deferrals under the 401(k) or 403(b) portions of the plan and for those made to the designated Roth account. Assets may not be transferred between a regular 401(k) or 403(b) plan and a designated Roth account.
- Individuals whose adjusted gross income exceeds certain limits may not contribute to a regular Roth IRA. There are no income limits applicable to a designated Roth account.
- For 401(k) plans, contributions to a designated Roth account are elective deferrals for purposes of the Actual Deferral Percentage (ADP) test.

### Contributions

A number of rules apply to contributions to a qualified Roth contribution program:

- **Dollar limitation:** For 2008, a maximum of \$15,500 may be contributed. Those who are age 50 and older may make additional contributions of \$5,000. A participant may choose to place all of his or her contributions in the regular 401(k) or 403(b) portion of the plan, all in the designated Roth account, or split the deferrals between the two.
- **Employer contributions:** Employer contributions will be credited to the regular 401(k) or 403(b) portion of the plan; they may not be designated as Roth contributions.
- **Excess contributions:** Excess deferrals to a qualified Roth contribution program must be distributed to the participant no later than April 15 of the year following the year in which the excess deferral was made. Otherwise, the excess deferral will be taxed twice, once in the year of deferral and a second time the year a corrective distribution is made.

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<sup>1</sup> The discussion here concerns federal income tax law. State or local income tax law may differ.

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### Distributions

A distribution from a designated Roth account will be excluded from income if it is made at least five years after a contribution to such an account was first made and at least one of the following applies:

1. The participant reaches age 59½;
2. The participant dies;
3. The participant becomes disabled.

Such distributions are known as “qualified” distributions. Other points:

- **Nonqualified distributions:** If a distribution does not meet the above requirements, it is termed a “nonqualified” distribution. Such distributions are subject to federal income tax, including a 10% premature distribution penalty if the distributee is under age 59½, in the year distributed. Such distributions are taxed under the annuity rules of IRC Sec. 72; any part of a distribution that is attributable to earnings is includable in income; any portion attributable to the original investment (basis) is recovered tax-free. This contrasts sharply with the taxation of nonqualified distributions from a regular Roth IRA account. Nonqualified distributions from a regular Roth IRA are taxed following pre-defined ordering rules under which basis is recovered first, followed by earnings.
- **First-time homebuyer expenses:** In a regular Roth IRA, a qualified distribution may be made to pay for first-time homebuyer expenses. This provision **does not apply** to distributions from a designated Roth account.
- **Rollovers:** A distribution from a designated Roth account may be rolled over into either a Roth IRA or another designated Roth account.
- **Required minimum distributions:** Generally, amounts in a designated Roth account are subject to the required minimum distribution rules applicable to plan participants when they reach age 70½. However, a participant can avoid the mandated distributions by rolling over amounts in the designated Roth account into a regular Roth IRA.

### Which Account To Choose?

The decision as to which type of account should be used will generally be made on factors such as the length of time until retirement (or until the funds are needed), the amount of money available to contribute each year, the participant’s current tax situation, and the anticipated marginal tax rate in retirement. An important issue to keep in mind is the overall, lifetime tax burden.

- **Regular 401(k) or 403(b):** Generally, individuals with a relatively short period of time until retirement, or who expect that their marginal tax rate will be lower in retirement, will benefit more from the regular 401(k) or 403(b) plan.

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- **Designated Roth account:** Younger individuals with more years until retirement and those who anticipate that their marginal tax rate will rise in retirement will generally benefit more from a designated Roth account. The fact that contributions to a designated Roth account are after-tax may cause current cash-flow problems for some individuals. Higher income participants may find that taxable income will be higher with a designated Roth account than with a regular 401(k) or 403(b) plan, potentially reducing tax breaks such as the child tax credit or AMT exemption.
- **Both:** Some individuals may choose to contribute to both types of plan, to provide flexibility in retirement.

### *Seek Professional Guidance*

Because of the complexities involved, the advice and counsel of tax and financial professionals is strongly recommended.